



February 24, 1967

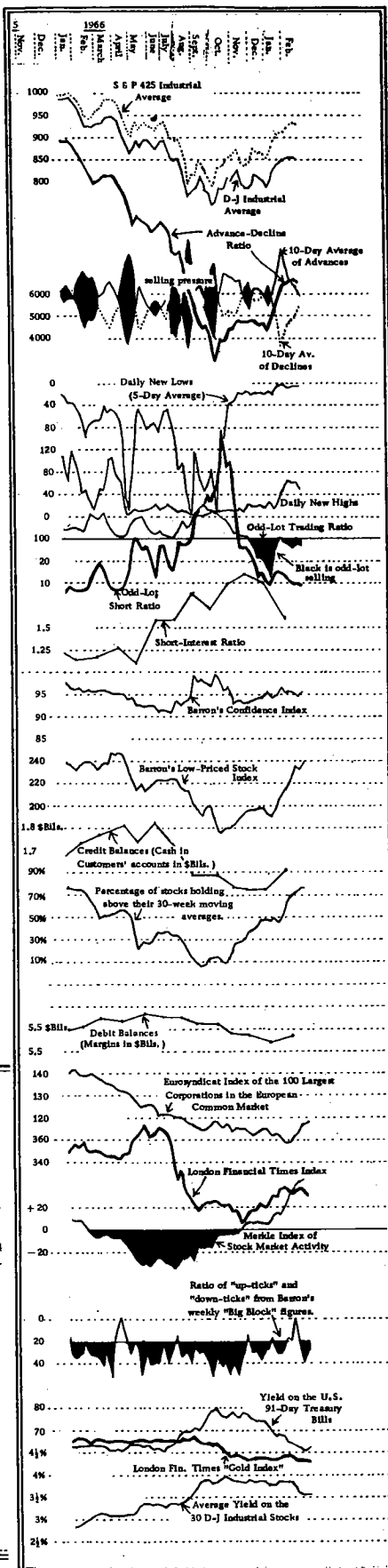
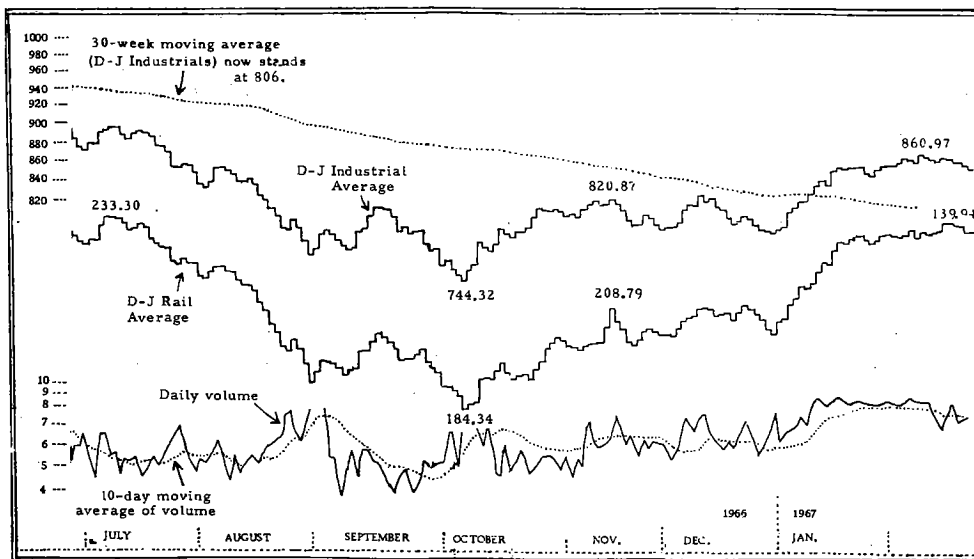
Letter 350

**THE MARKET:** "When the Averages disagree," wrote the great Dow Theorist Robert Rhea, "the market is saying 'watch out.' " One swallow does not make a spring, and one non-confirmation does not necessarily end a secondary (upward) correction in a primary bear market. But it is worth noting that the D-J Industrial Average recorded a recovery high on February 8 at 860.97. A week later the Rail Average scored a recovery high of its own at 230.99. The Rail high of February 15 was unconfirmed by Industrials. Although nothing has yet been proved and although the two Averages might still rally to further recovery highs, it is enough to say that the "danger flags" are flying. I say this because this divergence in the Averages has occurred within the framework of a full secondary in a primary bear market. Moreover, the divergence has come during a retracement which has lasted almost five months, a time element which suggests that this correction could end at any time. Two other considerations are that the divergence occurred just below the 50% level of the entire 1966 decline (see last Letter), and it has occurred amid frantic speculation on Wall Street.

Subscribers may remember that during early 1966 I drew attention to the strange action of the Industrial Average and the Low-Priced Stock Index. In April I noted (Letter 320) that despite a deep reaction in the Dow, the Low-Priced Stock Index (under the influence of frenzied speculation) had risen to a new high. I considered this freakish action to be bearish, and I wrote that the investment-grade stocks were being distributed under a smoke-screen of wild activity in the junk.

It seems to me that (on a smaller scale) the same thing has been happening during January and February of this year. Last week Barron's L-P Stock Index rose to 240.1, just 5 points from its 1966 high. Yet the Industrial Average had failed to recover even half its bear market losses. The ratio of volume in the L-P Index as compared to volume in the D-J Industrial Average rose (last week) to 40%, far above the "normal" ratio, which is nearer 10%. The picture is clear. Traders, sharp-shooters and speculators have been plunging into the "cats-and-dogs" and the "glamor stocks" while interest in the quality Dow stocks has been lagging. This type of action, coming as it did late in a secondary reaction in a primary bear market, is not considered bullish by this observer. It looks too much like early 1966 to make me anything but cautious about the picture from here on.

**CONCLUSION:** During a primary bear market when a series of indices turn down I believe it is proper to assume that they have "topped" until proved otherwise. There-



Page 2 fore, it is well to realize that the Utility Average recorded its recovery high of 139.94 as early as January 19, 1967, the D-J 40 Bond Average hit its peak of 83.56 on January 30, the Industrial Average touched a high of 860.97 on February 8, and the Rails established their peak of 230.99 on February 15. The primary trend of the market is bearish, the secondary trend is now doubtful, and the minor or daily trend is down.

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From another standpoint, we should remember that tight money played a major part in the 1966 collapse. I have been saying that I believe we are going to see more of tight money before 1967 if out. I can report that my chart of the yield on the bellwether 91-day Treasury bills "bottomed" in early February at 4.45% and it is now moving up into the 4.60% area. Even more dramatic is the giant glut which has enveloped the bond market as everyone and his brother piled in during the recent "breather" in interest rates. A large percentage of recent municipal bond flotations have not been sold to date, and last week the Bond Buyer yield index of municipal bonds leaped 21 basis points to 3.62%, highest level since January 5. The 21 point jump represented the biggest rise in this index since its inception in 1946! (see Notes & Quotes for more on bonds).

**FUNDAMENTALS:** The most important single fact for any investor to know is the direction of the primary trend. Ironically, there is never any proof of the primary direction until after the fact. Throughout history every major bull market has ultimately come to an end. The absolute end of a bull market is generally a deceptive affair. For every true bull market top there have probably been four or five secondary tops each of which (at the time) was taken to signal the "end of the bull market."

For instance, during the severe reaction following the huge 1956-57 secondary top almost everyone believed that a bear market had begun. Only long-term Dow Theory considerations cast any doubt at that time on the thesis that the bull market was over. Great bull markets usually end with average yields on the Dow Industrials at the 3.4% level or less; great bull markets usually end after a final "blow-off" in low-priced and speculative shares; major bull markets usually end after a massive entrance of the public and a period of high-volume speculation. None of those classic third phase characteristics had made their appearance during 1949 to 1957. And although the formation of the Averages suggested that a bear market had set in during 1957, later events showed that the primary bull market remained intact—even through the violent and costly 1957 decline.

The final proof of the "continuing bull market" thesis came in late 1958 when the old (i.e. 1956) highs were finally bettered. But the proof came late in the game. Only those few investors who had the courage to purchase stocks in late 1957 and early 1958 reaped the great profits from their conviction that the 1957 collapse was only a secondary in a major continuing bull market.

Today the tables are somewhat reversed. A small handful of analysts believe that a major bear market began in February, 1966. If those analysts are correct, then based on past history the great bull market of 1949 to 1966 will be followed by a primary bear market, a bear market which will fully correct all the abuses, excesses and distortion of the preceding 17-year bull market. The bear market can be expected to be major in both extent and duration. In all probability it will be both costly and deceptive. It

**NOTES & QUOTES:** In the last Letter I wrote about France, England, and the Common Market. I also mentioned that France is now demonstrating the strength of the franc against the dollar. For while the U.S. is asking for a doubling of the equalization tax (from 15% to 30%), deGaulle has announced that the franc is now fully convertible. This announcement could not have come at a worse time for the U.S. For it has come at a time when the prime rate has just been reduced and when interest rates in the U.S. have eased. Furthermore, a fully convertible franc means that those nations which are building up dollar reserves and which have been too embarrassed to turn those dollars in to the U.S. for gold have an outlet. They can sell their dollars for French francs (at Paris), and the French can turn in the dollars to the U.S. for gold.

Economist Eliot Janeway had some important things to say about the situation in his latest Janeway Service report (311 E. 50th St., N.Y.C. 10022): "New French Power Play. The fact that the War is very much on is having repercussions as direct and powerful — and, we believe, as bearish — in the European financial arena as in the domestic political arena. In particular, de Gaulle's decision to free the movement of gold in and out of Paris spells trouble so long as Johnson remains unwilling to acknowledge the need for a drastic overhaul of dollar defenses. The thrust of the French decision is to put Paris into competition against London in the world's gold market. The London gold market is, of course, a controlled market subject to the operations of the Stabilization Fund which, in line with Washington's determination to prevent a rise in the price of gold, intervenes when and as needed to prevent sustained gold market upticks. The Stabilization Fund does this by selling enough gold to hit bids whenever the price of gold starts to move up.

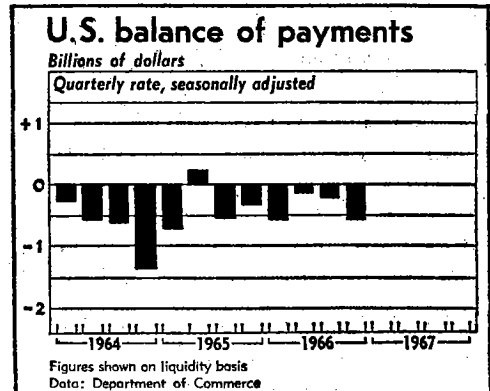
"The new move to set Paris up as an alternative market beyond the reach of the Stabilization Fund is aimed to give South Africa, Russia and other large sellers a chance to get out from under the Stabilization Fund; and it is also aimed to do the same for the gold bulls. The only way in which the United States will be able to keep the Paris market down will be by dumping enough gold to hit bids there directly. The powers-that-be in Paris profess to be satisfied if things go this way because, in that case, to use the French Government's word, America's gold losses will 'hemorrhage.'"

Johnson's 6% tax proposal seems now almost to be forgotten. The coming budget deficits (particularly in view of the continuation of the Vietnam war) promise to be whopping. On top of this, we have the new deGaulle offensive against the dollar. All of this is calculated to bring a new downtrend in the bond market and a return to tight (should I say tighter) money. The place to look for the coming trend in the stock market is almost surely the bond market. I suggest subscribers watch bond prices and yields with utmost attention from here on.

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Another place where subscribers might now look intently is the price of gold shares. U.S. monetary students watch the liquidity balance in this nation. This measures dollar liabilities to all foreigners, plus gains or losses in official U.S. reserves. On that basis the U.S. deficit last year was \$1.42 billion against 1965's \$1.33 billion.

Last year U.S. imports rose 19% while exports rose only 11%. The U.S. merchandise surplus in 1966 fell to \$3.7 billion against 1965's \$4.8 billion. The U.S. tourist deficit was also \$1.8 billion, up a bit from 1965. What really helped the U.S. balance-of-payments during 1966 was tight money. During the third quarter of 1966 there was a massive transfer of foreign capital to the U.S. due partly to pressure on sterling but mainly due to the very attractive U.S. interest rates. If interest rates are eased now, much of this foreign capital could leave the U.S., thus putting severe pressure on the dollar. This situation alone almost eliminates the possibility of lowering the discount rate in this country. Note on the chart that the U.S. balance-of-payments deficit during the 4th quarter of 1966 jumped to an annual rate of \$2.2 billion, the worst since the first quarter of 1965. Any worsening of this situation will almost surely be reflected in a rise in gold shares.



will separate a great many investors from their money, and it will purge the economy of the "fat" that has been built into it since 1949.

If a bear market truly did start in early 1966 then by definition the Averages (during any upward correction) will fail to better the 1966 bull market highs. Furthermore, each rally will (in due time) fade out, only to be followed by fresh new lows. This process will continue until the worst that can be seen ahead is fully discounted in the price structure.

If history repeats, then in a matter of a few years or so bullish psychology will turn to bearish sentiment, volume will diminish drastically on the exchanges, economic troubles will increase, and the Averages will probe new low ground for the bear market.

Ultimately, the bear market will show signs of being completely "sold out." Common stocks will be unpopular, interest in Wall Street will be minimal, average yields on high-grade stocks will be high, and most blue-chips will be on the bargain counter. The market will develop a great resistance to bad news, and the Averages (amid very low volume) will assume a sideways, dragging pattern. The true investor will not be pressured to rush in and buy the great values. The values will be "sitting there" for the asking. Popular analysts will list 100 reasons why stocks have no future, and market oracles will recount why "this time it is different" and why "no great bull market will ever again be seen in our lifetime."

CONCLUSION: I believe a primary bear market began in February, 1966. If this is true then the best policy for investors is to stay out of equities and let the bear market run its course. If a bear market is now in progress, then regardless of the strength of any recovery the 1966 highs will not be bettered. Moreover, all upward correction will be followed by eventual new lows in the Averages. Those who believe in the bear market theses are going to be subject to ridicule and counter-argument, for it must be remembered that Wall Street and the public want to be bullish and they will believe what they want to believe. In the final analysis, the great fortunes in the market have been made by those who saw the primary direction of values and had the patience and fortitude to set their investment programs accordingly. Simple as this procedure may sound, it is the most difficult thing in the world to do.

QUESTION: Shouldn't the D-J Industrial Average be adjusted over the years for inflation and the shrinking value of the dollar?

ANSWER: Under Dow Theory tenets, the Averages are taken to be self-adjusting. During extended periods of inflation many stocks sell for higher price-earnings ratios than is the case during depression periods. Thus today's "normal" range of roughly 14 to 19 times earnings for the Dow might change to 6 to 10 times earnings during an extended bear market. How many people might then want to "adjust the Dow downward" to compensate for deflation?

QUESTION: What's wrong with the Dow? I see that S & P's 425 Industrial Average has retraced nearly two-thirds of its 1966 losses while on a closing basis the Dow has failed to recover half its losses. The Dow doesn't represent the market, so what good is it?

ANSWER: Although the Dow almost always moves in direction with other broader indices, it also usually moves in amplitude with those indicators. The 1967 recovery represents a rather rare discrepancy in amplitude. Nevertheless, other Indices such as the New York Times Stock Average have failed to regain even as much ground as the Dow.

It should be remembered that the Dow was designed as an "investment-grade" index, and it was never supposed to represent all stocks on the Exchange. If we want to know what the investment-grade blue-chip giants are doing, we watch the Dow. These stocks represent almost 40% of the value of the entire New York Stock Exchange, and it is almost impossible to envision these 30 great corporate enterprises doing poorly while the rest of the country prospers. By the same token, what's good for these 30 Dow stocks will almost always rub off on the rest of the nation's business.

Of particular interest to Dow Theorists is the fact that we have the actual record of the Dow and the interpretations of its movements by Dow Theorists going back before the turn of the century. Thus there is an historical continuity and a basis of comparisons in the Dow Averages which is enjoyed by no other indices. Analysts are interested in what the Dow Averages did in 1907, 1929, 1932, 1942, 1946, etc. No one really cares what a retroactive reading on some geometric average may show. To plot some new average during a key year like 1937 somehow reminds me of the constant retort of a famous radio comedian of yesteryear--"Vas you dere, Charley?"

ECONOMY: Letter 347 contained a detailed study of Automobile sales. Since then the sales figures for the first 10 days of February have been tabulated. The slumping trend continues with sales down 21% for the first 10 days of February over the same period last year.

This is most interesting because it points up one major potential fallacy in the thinking of the New Economists. It is generally accepted by government economists that the supply of credit has an almost direct relationship to the demand. If credit is tightened consumers will decrease their buying, and if credit is loosened people will start buying again. Such action (with variations) may be roughly true during a primary bull market, but during a primary bear market overflowing credit is by no means a guarantee that people will go back and "drink at the trough."

the year 1930 was to spend his available cash

**Page 4** Interest rates were extremely low during most of the 1930's and credit was generally available to well-rated customers, but people were of little mind to buy. Today, the average person is far more willing to go into debt than his counterpart in 1930 was to spend his available cash. The psychology has changed. The major difference is the confidence of the citizen of today versus the suspicion and fear of the man of 1933 or 1939.

The question now is whether easier money is apt to stimulate demand for more plants and equipments, higher inventories, more appliances and autos. All of these items have been bought in large quantities over recent years, and an easing of the money supply and rates is not likely to stimulate this same demand again any time soon.

Market action of the past year contains all the characteristics which go to produce a long, slow, tortuous primary bear market. Think of it, autos sales are slumping, housing and appliance sales are poor, inventories are huge throughout the nation. Ordinarily this would spell very obvious economic trouble. But much of this trouble is being somewhat obscured by the vast government spending for Vietnam.

Nevertheless, there has been a consistent siphoning off of economic activity from the private sector (which generates profits) to the Government sector (which ordinarily generates few if any profits). On a year to year basis, Government spending in the 4th quarter of 1966 rose 10% whereas spending in the private sector gained only 2%. This is going to be reflected increasingly in profits as this primary bear market unwinds.

On February 21 the Commerce Department announced that durable goods orders dropped 5.1% in January, reflecting reduced bookings in "almost every industry." It also stated that the 4th quarter inventory buildup was at the record rate of \$16.5 billion instead of the earlier announced figure of \$14.5 billion. The little chart from the New York Times shows the story rather dramatically. Sales are leveling or turning down while inventories sky-rocket. Ultimately there is going to be a scramble to get rid of inventory, and it should be something to see. This will mean lowered production in the face of the almost guaranteed rising costs of 1967. Already many profit statements are reflecting the squeeze, a squeeze which is sure to intensify as 1967 grows older.

**CHART OF THE WEEK:** I noted earlier that Barron's Low Priced Stock Index was churning up volume at a high (speculative) rate during February of this year. The accompanying chart shows the Amex volume as a percentage of the N.Y.S.E. volume has also been rising. The profile of this chart suggests to me that the current rally is a sort of mini-edition of the first quarter of 1966. Speculation is again rampant, volume is again running high, and almost all "high flying" divisions of the stock market are outperforming the investment-grade Dow stocks. Along these lines it is worth noting that on February 20 the D-J Utility Average closed at 136.73, the lowest level since January 2, and only a slight fraction from a new low for the year. The Utility Average is sensitive to interest rates, and it also reflects the sentiments of the highest level of investment thinking. (Chart of Amex volume courtesy of Merrill Analysis, Box 228, Chappaqua, N.Y. 10514).

**STOCKS:** It appears to this writer that both gold and silver shares have completed the reactionary phase which characterized these stocks' action last year (see accompanying charts). The gold picture will become increasingly acute this year as foreign nations take an increasingly jaundiced view of U.S. monetary policy.

The silver situation is accelerating at a faster rate than many believed possible even a few months ago. Within less than a year the U.S. will either have to release the backing behind silver certificates or dig further into the official U.S. stockpile of silver. Regardless, the pressure will be up for the price of silver and the stocks are reflecting this. Hecla is the class of the silver issues, and Day Mines is my speculative favorite. (Small charts courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas).

